National Commission on Inflation	Commission nationale de l'inflation

focus

volume 1 no. 2

July 19, 1979

Oil Prices and Inflation

Foreword by the Chairman

A major impact on the Canadian economy this year will come from the very large increases in world oil prices, both those of recent months and those now being implemented by the OPEC nations. Canadians are concerned, and rightly so, about what this will mean for them. I believe that if the Canadian public is adequately informed of the issues at stake, and reacts in a responsible way, some of the potential damage can be avoided. What follows is an effort to answer some questions on this complex and vital issue. It does not attempt to deal with every aspect, but rather centres on problems of inflation for which the Commission has a particular concern.

Harold A. Renouf

Q. What will the higher prices for world oil mean for inflation in Canada?

A. This will depend, in part, on how Canada decides to absorb the increased cost of imported oil into the Canadian economy. In the past, part of such increases have been offset through subsidy and part has been passed on to consumers through higher prices.

Q. Doesn't it make sense to shelter Canadian consumers against the higher world costs?

A. We can't really be sheltered. Canada imports some 475,000 barrels of oil per day to supply eastern Canada, so higher world oil prices are an inescapable fact of life. Existing policy is to maintain basically the same price for crude oil across Canada. Thus all Canadians shoulder the cost of an increase, whether through higher market prices or federal subsidy or a combination of both.

Q. How does the Canadian crude oil price compare with world prices?

A. The price for Canadian-produced oil, at the wellhead, rose $1 a barrel to $13.75 on July 1. OPEC prices are quoted in U.S. dollars and before the latest round of increases the average landed cost of imports at Montreal was around $US 18 or about $21 Canadian. The impact of the latest OPEC price increases is not yet clear. The average Canadian import price reflects a blend of imports from several countries but even the most moderately priced OPEC oil, from Saudi Arabia, has increased by $US 3.45 per barrel.

Q. Say we cover these increases through higher prices in Canada, isn't that inflationary? What will it do to the Consumer Price Index?

A. It has been estimated that the $1 a barrel increase in the crude oil price which took effect July 1 will mean an increase of between one-half and three-quarters of one per cent of the CPI after secondary cost effects work through to consumers. The initial impact on consumer prices will be delayed 60 days while lower-cost inventories are being used. Gasoline and heating oil prices will rise by 3 to 5 cents per gallon on September 1 and natural gas prices will be similarly affected. Then there will be secondary effects on costs in industry. For example, agriculture, transportation and petrochemical industries are intensive users of petroleum. Oil is needed both to power machines and as a raw material for products such as plastics, synthetic fibres and fertilizer. Much of Canada's electricity, especially in the Maritimes and western Canada, is generated from oil or gas. It could take as long as two years for all of these costs to work through to consumer prices. If the response by Canadians is to seek fully compensating increases in their incomes, it has been estimated that the eventual impact of both higher costs and wages could be as much as one per cent of CPI for each extra $1 per barrel.

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Q. Is there any way a consumer can avoid this higher cost of living?

A. The Consumer Price Index measures a fixed "basket" of goods and services; it doesn't automatically adjust to changes by consumers in their buying patterns. Each consumer can adjust his own cost of living by careful shopping, substituting away from higher-priced goods, and by conservation. In our present circumstances energy conservation becomes increasingly important. By driving fewer miles in the family car or switching to a more energy-efficient model, for example, one can make savings that will help offset the increased price at the pump. Better insulation, and turning down the thermostat, are effective responses to the higher prices of home heating oil or gas. Thus although the CPI may go up, there are ways of keeping one's own expenditures down. If this kind of conservation is adopted by all Canadians, it could go a long way toward offsetting the world price increases. In both home and industry there are many ways of achieving more efficient use of energy resources.

Q. Isn't the obvious answer for Canadian workers to get higher wages and salaries to offset the higher prices?

A. That's an understandable reaction, but it won't work. The OPEC oil price increases mean, inevitably, a transfer of wealth out of Canada -- a real reduction in our purchasing power. If we try to recover that purchasing power right away by getting higher wages or boosting other prices, it will only add to inflationary pressures in Canada. We can achieve real growth in incomes only by increasing our collective output of goods and services.

Q. Isn't that asking for a lot of restraint?

A. Yes. But the Commission believes that if Canadians are adequately informed of the problem they will take responsible actions, accept the need for greater conservation, and not try to recover their shares of the OPEC increase out of next week's wage increase or tomorrow's price increase.

Q. Wouldn't a higher import subsidy avoid these consumer price problems?

A. It would mean the federal treasury rather than the consumer would finance the OPEC increases. But the increases would still have to be paid for in the end. And Canadians should be aware of the cost of the subsidy. With the price gap between Canadian and world oil growing wider in the past year, the import subsidy rose from an average of just over $3 a barrel in 1978 to around $8 a barrel by early June. The latest OPEC increase intensifies this problem. The subsidy is financed by a tax on our oil exports to the United States and by a special excise tax of seven cents a gallon on gasoline. While those taxes were enough in 1978 to cover the import subsidy, they will fall short this year. The answer is either to finance the growing subsidy from general government revenues or to accept an additional price increase.

Q. Which of these alternatives is preferable?

A. Either way involves costs to the economy. Allowing higher crude oil prices means a more direct impact on consumer prices, and higher production costs for industries will affect their competitive position. On the other hand, a higher subsidy still must be paid for by higher taxes or increased deficit, while the artificial hold-down of oil prices reduces the incentives to use energy more efficiently and also limits prospects for developing new oil resources and alternate energy sources. Any solution will have to try to reconcile the wide differences in the economic interests of the various regions of Canada. While some continuing level of subsidy for eastern Canada's oil imports seems necessary, it appears that Canada's energy costs should continue to adjust, gradually, towards the world price.

To sum up, although we cannot avoid the cost of higher world oil prices, we still have the option of meeting the challenge in a responsible way so as to minimize its inflationary impact.

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Communications: 995-3038

National Commission on Inflation
Commission nationale de l'inflation

focus

volume 1 no.1

June 27, 1979

INTRODUCING FOCUS: An important part of the mandate of the National Commission on Inflation is to promote public understanding of the inflationary process and its implications for the economy. That is the aim of this newsletter. Through Focus, the Commission hopes to increase public awareness and understanding of the developments which could have important consequences for inflation and our general economic health. And since communication should be a two-way street, we will welcome the views and suggestions of our readers.

Harold A. Renouf, Chairman

On Reading Economic Road Signs

A motorist who misinterprets the road signs may end up lost. The National Commission on Inflation is concerned that the players in Canada's economy, in both business and labour, avoid a similar fate.

NCI Chairman Harold A. Renouf says that two current economic road signs can be misinterpreted. One is the present rate of increase in the Consumer Price Index; the other is a recent surge in corporate profit levels.

"Both numbers are high", Mr. Renouf notes. "The danger is that long-lasting price and wage decisions may be made on the mistaken premise that current levels of CPI and profits will persist.

"If this happens -- if inflated costs and prices get built into the economy -- then an erroneous expectation of higher inflation could turn into a self-fulfilling prophecy."

Many economic commentators have pointed to the obvious: that the Consumer Price Index is rising about as rapidly now as it did three years ago. For the first quarter of 1979, the year-to-year advance in CPI was 9.1 per cent compared with 9.3 per cent in the first quarter of 1976.

But there are important differences between the two numbers. Three years ago food prices in the CPI had risen by a modest 7.4 per cent compared with the 15.9 per cent advance in food prices during the first quarter of 1979. However, the non-food component of the CPI was registering an increase of 9.9 per cent during the first quarter of 1976; three years later that had moderated to 6.7 per cent.

Thus the inflation rate for non-food goods and services in the CPI, covering about three-quarters of consumer purchases, has been cut by a third in three years. Food prices, in contrast, have swung wildly, and their present high levels are due mainly to weather and harvest-related shortages, exchange rate depreciation and the beef cycle. Food price increases can and will moderate with improved supplies.

The Commission's concern is that long-lasting changes in price and wage structures should not be based on transient price pressures.

The same concern applies to the sudden upswing in the annual CPI rate to 9.8 per cent in April from 9.2 per cent in March. That related, not to any price acceleration this spring, but rather to the cut in provincial sales taxes in April, 1978. More recently, moderation in food prices helped to cut the CPI increase to 9.3 per cent in May compared with a year earlier.

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Corporate profits registered strong advances in the latter part of 1978 and early this year. That resulted from a combination of factors. For one, unit labour costs rose only moderately. At the same time a continued decline in the exchange rate pushed up the Canadian dollar price of internationally-traded goods. On top of that, sales expanded rapidly, putting idle plant and equipment to work and further improving unit costs. The outcome of all these was a strong upsurge in corporate profits.

An important question is whether this development will lead to another round of accelerating wage settlements. There are some signs of an upturn in the size of wage increases.

The Commission expects, however, that the recent level of profit advances will not be maintained. Slower growth in prices, a slowing in export markets, and faster growth in costs this year are likely to reduce the rate of profit growth.

The Commission has therefore cautioned against the danger of going too far in building large wage advances into our production costs on the basis of temporary factors.

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Forest Products Industry – Profits and Wages

Profits in Canada's big forest products industry have been riding high on the strength of export sales and the Canadian dollar devaluation.

The industry's continued competitiveness in the short run depends largely on the dollar's future value. For that reason, the outcome of current collective bargaining on the West Coast, involving over 47,000 workers, could be of critical importance for the future of the industry.

The National Commission on Inflation will be monitoring the situation closely. If substantial new wage costs are built into the West Coast industry on the basis of windfall profits from devaluation, it could weaken the industry's competitive position and leave it vulnerable to a rise in the dollar's exchange rate.

Eastern Canadian labour settlements in the forest industry have been quite moderate in the past year, with wage increases not outrunning inflation. On the West Coast, collective bargaining is more concentrated, with master agreements between three employer groups and four unions all expiring this month. One important concern to the Commission is the demonstration effect which a large settlement would have in other industries.

An industry study by NCI staff demonstrated the sharp upturn in profits brought about by devaluation of the dollar. Profits in the paper and allied industries and forestry rose from $354 million in 1977 to $715 million in 1978, and in the wood and furniture industry from $255 million to $500 million.

During 1975-77 profits were relatively low. The industry lagged behind U.S. competitors on a number of points: less accessible forest resources, higher transport costs to market, some old and inefficient plant and equipment, and higher wage rates which in 1977 were reported to be 18 per cent above wage rates in the U.S. industry.

In the last year, the depreciation of the dollar has largely offset those cost disadvantages, allowing Canadian firms to compete in wider markets. These disadvantages remain however, although major new investments are being planned to modernize plants and equipment.

Since most of the industry's exports are paid for in U.S. dollars, depreciation of the Canadian dollar has had a dramatic effect on corporate profits. This was reinforced last year by strong demand in U.S. markets, especially lumber for house-building. It is estimated that each new home in the U.S. uses on average about $2,500 worth of Canadian lumber.

While a slowdown in U.S. housing starts this year has moderated the pace of price increases for wood products, the prices of paper products have continued to rise in the face of short supplies.

There have also been dramatic increases in utilization rates of available plant and equipment capacity, leading to lower unit costs and higher profitability. In the paper and allied industry, for example, capacity utilization rose from 72.6 per cent in 1975 to 91 per cent in 1978.

(Reference: Ken Waldie, Director, Natural Resources Division, 593-5607)

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Beef and Shoes: A Common Factor

You might call it the heifer factor.

The same situation that has boosted beef prices is also putting strong pressure on shoe prices. The common factor in both cases is the decline in numbers of cattle slaughtered as beef farmers try to build up their herds.

The resulting shortage of hides has brought about a sharp jump in leather prices -- up 54 per cent in February on tannery shipments compared with a year earlier. This is the material now in spring footwear lines and being ordered for fall lines.

Since leather represents 40 per cent or more of shoe manufacturing costs, consumers can expect substantial increases in shoe prices next fall. The Shoe Manufacturers' Association of Canada has said prices could rise as much as 20 per cent on fall lines.

The Chairman of the National Commission on Inflation, Harold A. Renouf, says it is important for consumers to recognize the causes behind such an increase.

"This is an exceptional case, and should not be taken as a pattern for other prices."

Rates of cattle slaughter are down in many countries, especially in North America, Australia and New Zealand, so prospects for an early easing of hide prices are not good. Heifers which at other times might eventually be killed for hamburger meat are instead, at this stage of the beef cycle, being kept as breeders in order to build up beef cattle herds.

The close link between supplies of beef and hides has led to wide swings in hide prices. During the 1970s, year-to-year changes have ranged from an increase of 164 per cent to a price drop of 59 per cent. So the present high rate of increase of both beef and hide prices is temporary and can be expected to moderate when rates of cattle slaughter increase later in the beef cycle.

Import quotas are another factor bearing on shoe production and prices. Quotas were placed on imports of foreign footwear in December, 1977, after the Anti-Dumping Tribunal found they were causing or threatening serious injury to Canadian shoe production.

The resulting upswing in output of Canadian shoe factories has taken up some slack in idle plant capacity. This should allow manufacturers to offset some of the higher leather costs through production efficiencies. The quotas also protect employment in the industry.

The restriction on the volume of imported footwear, by limiting competition, may also lead to higher prices for both domestic and imported shoes.

(Reference: Brian Molloy, Director, Manufacturing Division, 995-1345)

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Mining and Smelting Industry: Wage Settlements

The general level of wage settlements in the mining and smelting industry is of concern to the National Commission on Inflation, and a study will be made of compensation trends in the industry.

The decision follows an NCI analysis of the collective agreement ratified June 3 between Inco Limited and the United Steelworkers Union, which ended an $8\frac{1}{2}$ month strike by 11,000 employees. The settlement is reported to have provided for \$2.83 increase in average hourly wages and \$1.24 in added benefits over three years.

The NCI analysis indicated that the trend of actual wage levels in the new Inco agreement is generally consistent with wage levels elsewhere in the mining industry. However, the Commission is concerned with the over-all trend of settlements in the industry, which have been considerably larger than the average for the economy as a whole.

The Commission recognizes that, in many cases, settlements of this size are made possible by improved export markets and strong growth in productivity in the mining industry. Since they involve products, like nickel, which are mainly exported, they do not represent a serious source of domestic cost-push inflation.

However, they have important demonstration effects on workers in other industries where there is slower productivity growth and a more direct impact on domestic markets. The extension of the mining industry wage pattern into such industries could have more serious inflationary effects.

The Commission has studied wage settlements during the post-control period in the mining and smelting industry, including an assessment of the impact of cost of living adjustment provisions (COLA clauses). Assuming an 8 per cent annual increase in the Consumer Price Index, the average annual wage increase in 16 such settlements to April 30 would be some 10.7 per cent over the life of the contracts. The Inco settlement would boost this average to an estimated 11.0 per cent.

(Reference: David McPherson, Natural Resources Division, 995-4754)

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Inflation is Prime Public Concern

The problem of inflation has been consistently at the forefront of Canadians' concern in recent years, and that fact was confirmed in a Gallup poll earlier this year.

Nearly two-thirds of those surveyed (63%) ranked inflation among the top three problems facing Canada. It was on a par with unemployment as a top concern, while national unity ranked third.

The poll, based on interviews earlier this year of a representative cross-section of 2,057 adults, was commissioned by the Centre for the Study of Inflation and Productivity. Its findings are broadly consistent with those of opinion polls during the last three years.

Some of the other main findings of the poll:

--Factors seen as the leading causes of inflation were labour union demands (30%), the desire of business for profit (19%), the general public's lifestyle (15%),"buy today, pay tomorrow" (15%) and federal spending on social programs (12%).

--Almost everyone (91%) expected prices would rise faster than their family income over the coming year.

--Almost two-thirds (63%) expected inflation in 1979 would exceed last year's increase of 9 per cent in the Consumer Price Index.

--The same proportion believed federal economic policies can influence inflation -- either "a good deal" (31%) or "somewhat" (34%).

--Three out of four felt Canada's inflation is a result of inflation in other countries--31% felt a large part and 41% a small part was caused by foreign factors.

--18% felt Canada has done better than other countries in controlling inflation, 22% felt we have done worse and 54% felt we have done "about the same".

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